Capitol Energy
Resources Ltd.

Audited Financial Statements of

CAPITOL ENERGY RESOURCES LTD.

Year ended December 31, 2006

MANAGEMENT'S REPORT TO THE SHAREHOLDERS

Management has prepared the accompanying financial statements of Capitol Energy Resources Ltd. in accordance with Canadian generally accepted accounting principles. Financial and operating information presented throughout this Annual Report is consistent with that shown in the financial statements.

Management is responsible for the integrity of the financial information. Internal control systems are designed and maintained to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce reliable accounting records for financial reporting purposes.

KPMG LLP was appointed by the Company's shareholders to perform an examination of the corporate and accounting records so as to express an opinion on the financial statements. Their examination included such tests and procedures, as they considered necessary, to provide reasonable assurance that the financial statements are presented fairly in accordance with Canadian generally accepted accounting principles.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises this responsibility through the Audit Committee, with assistance from the Reserve Committee regarding the annual evaluation of Capitol's petroleum and natural gas reserves. The Audit Committee meets regularly with management and the independent auditors to ensure that management's responsibilities are properly discharged, to review the financial statements and recommend that the financial statements be presented to the Board of Directors for approval. The Audit Committee also considers the independence of the external auditors and reviews their fees. The external auditors have access to the Audit Committee without the presence of management.

"Signed"

R.L. (Monty) Bowers
President and Chief Executive Officer

"Signed"

Doug Dearing
Vice President, Finance and Chief Financial Officer

Calgary, Canada
March 8, 2007

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the balance sheets of Capitol Energy Resources Ltd. as at December 31, 2006, and 2005 and the statements of operations, and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006, and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Signed "KPMG LLP"
Chartered Accountants

Calgary, Canada
March 8, 2007

Balance Sheets

As at December 31 *(thousands of dollars)*	**2006**	2005
ASSETS		
Current:		
Cash and cash equivalents	**$ -**	$ 4,232
Accounts receivable	**7,369**	5,251
Other current assets	**309**	264
Financial derivative contracts (note 10)	**571**	-
	8,249	9,747
Property and equipment (note 3)	**176,017**	116,232
Future income tax asset (note 7)	**6,232**	10,545
	$ 190,498	$ 136,524
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current:		
Accounts payable and accrued liabilities	**$ 14,106**	$ 20,150
Bank loan (note 5)	**33,723**	-
	47,829	20,150
Office lease inducements	**26**	31
Asset retirement obligation (note 6)	**2,379**	1,641
	50,234	21,822
Shareholders' equity:		
Share capital (note 8)	**126,844**	105,864
Contributed surplus (note 8)	**9,569**	6,203
Retained earnings	**3,851**	2,635
	140,264	114,702
	$ 190,498	$ 136,524

Commitments (note 12)

See accompanying notes to financial statements

"Signed" "Signed"

R.L. (Monty) Bowers, Director

Sheldon Reid, Director

Statements of Operations and Retained Earnings

For the years ended December 31 *(thousands of dollars except per share amounts)*	**2006**	2005
Revenues		
Petroleum and natural gas	**$ 54,070**	$ 19,803
Royalties, net of Alberta Royalty Tax Credit	**(13,092)**	(4,988)
Unrealized gain on financial derivatives (note 10)	**571**	-
Interest	**20**	181
	41,569	14,996
Expenses		
Production	**4,178**	1,354
Transportation	**3,364**	1,640
General and administrative	**3,926**	3,246
Stock based compensation (note 9)	**2,946**	5,025
Depletion, depreciation and accretion	**21,831**	7,910
Interest	**1,212**	385
	37,457	19,560
Net income (loss) before taxes	**4,112**	(4,564)
Current income tax expense (note 7)	**26**	88
Future income tax expense (recovery) (note 7)	**2,870**	(13,652)
Net income	**$ 1,216**	$ 9,000
Retained earnings (deficit), beginning of year	**2,635**	(6,365)
Retained earnings, end of year	**$ 3,851**	$ 2,635
Net income per share, basic and diluted	**$ 0.02**	$ 0.23
Weighted average number of shares outstanding (000's) (note 13)		
basic	**50,240**	39,617
diluted	**50,568**	39,835
Shares issued and outstanding (note 8)	**52,975**	47,988

See accompanying notes to financial statements

Statements of Cash Flows

For the years ended December 31 *(thousands of dollars)*	**2006**	2005
Operating activities:		
Net income	**$ 1,216**	$ 9,000
Unrealized gain on financial derivatives	**(571)**	-
Depletion, depreciation and accretion	**21,831**	7,910
Stock based compensation	**2,946**	5,025
Office lease inducements	**(5)**	2
Future income tax expense (recovery)	**2,870**	(13,652)
Expenditures on abandonments	**-**	(110)
	28,287	8,175
Changes in non-cash working capital	**(525)**	(1,718)
	27,762	6,457
Financing activities:		
Net change in bank loan (note 5)	**33,723**	-
Issuance of subscription receipts	**-**	50,000
Issuance of shares (note 8)	**23,489**	35,519
Share issue costs (note 8)	**(1,375)**	(4,994)
Exercise of warrants	**-**	198
Exercise of options (note 8)	**192**	49
	56,029	80,772
Investing activities:		
Property and equipment expenditures	**(80,341)**	(60,829)
Acquisition of Tiger shares (note 4)	**-**	(49,514)
Cash acquired on acquisition of Tiger	**-**	3,430
Changes in non-cash working capital	**(7,682)**	9,849
	(88,023)	(97,064)
Change in cash and cash equivalents	**(4,232)**	(9,835)
Cash and cash equivalents, beginning of year	**4,232**	14,067
Cash and cash equivalents, end of year	**$ -**	$ 4,232

Supplemental cash flow information (note 13)

See accompanying notes to financial statements

1. Nature of Business

Capitol Energy Resources Ltd. ("Capitol" or the "Company") is a public company engaged in the exploration, development and production of crude oil and natural gas in Alberta and British Columbia.

2. Significant Accounting Policies

(a) Basis of presentation

The financial statements include the accounts of Capitol and have been prepared in Canadian dollars in accordance with Canadian generally accepted accounting principles.

(b) Measurement uncertainty

The preparation of the financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingencies, if any, as at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Amounts recorded for depletion, depreciation and asset retirement obligations and amounts used for the ceiling test calculation are based on estimates of oil and natural gas reserves, future costs required to bring those reserves to production, commodity prices and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty.

(c) Cash and cash equivalents

Cash and cash equivalents consist of cash balances with banks and short-term investments with original maturities of less than three months. The fair value of cash and cash equivalents approximates the amounts shown in the financial statements.

(d) Petroleum and natural gas properties

(i) Capitalized costs

The Company follows the full cost method of accounting whereby all costs relating to the acquisition of, exploration for and development of oil and gas reserves are capitalized in a single Canadian cost center. Such costs include: lease acquisition, lease rentals on undeveloped properties, geological and geophysical, drilling both productive and non-productive wells, production equipment and facilities, general and administrative expenses and stock based compensation expenses that are directly related to exploration and development activities.

(ii) Depletion and depreciation

All costs of acquisition, exploration and development of oil and natural gas reserves, associated tangible property and equipment costs (net of salvage value), and estimated costs of future development of proved undeveloped reserves are depleted and depreciated by the unit of production method based on estimated gross proved reserves as determined by an independent qualified reserves evaluator.

Costs of unproved properties are initially excluded from oil and gas properties for the purpose of calculating depletion. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion.

The relative volumes of oil and natural gas reserves and production are converted to equivalent barrels of oil on a 6 mcf to 1 boe basis.

Depreciation of office furniture and equipment is provided for at rates ranging from 20% to 50%.

(iii) Ceiling test limitations

The Company places a limit on the net carrying value of capital assets to a cost recovery test (the "ceiling test"). The ceiling test is a two-stage process which is to be performed at least annually. The first stage of the test is a recovery test which compares the undiscounted future cash flow from proved reserves at forecast prices plus the cost less impairment of unproved properties to the net book value of the petroleum and natural gas assets to determine if the assets are impaired. An impairment loss exists when the net book value of the petroleum and natural gas assets exceeds such undiscounted cash flow. The second stage determines the amount of the impairment loss to be recorded. The impairment is measured as the amount by which the net book value of the petroleum and natural gas assets exceeds the future discounted cash flow from proved plus probable reserves at forecast prices. Any impairment is recorded as additional depletion and depreciation.

(e) Joint operations

Portions of the Company's oil and gas exploration and development activities are conducted jointly with industry partners and accordingly the financial statements reflect only the Company's proportionate interest in such activities.

(f) Asset retirement obligation

The fair value of the liability for the Company's asset retirement obligation is recorded in the period in which it is incurred with a corresponding increase to property and equipment. The liability is computed by discounting the estimated future value of the obligation using the Company's credit adjusted risk-free interest rate. The provision for asset retirement obligation is revised for the effect of any changes to timing related to cash flow or estimates of future abandonment costs.

The liability is accreted each period and the associated capitalized cost is depleted or depreciated over the useful life of the related asset.

(g) Income taxes

The Company uses the liability method of tax allocation in accounting for income taxes. Under this method, future income tax liabilities and future income tax assets are determined based on differences between the financial reporting and tax basis of assets and liabilities, and measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. Future tax assets are recorded when it is "more likely than not" the future tax asset will be realized.

(h) Revenue recognition

Oil and natural gas sales are recognized as revenue when the commodities are delivered to purchasers.

Revenues, expenses and sales volumes from acquisitions are recorded for financial statement purposes from the date the transaction closes. Revenues, expenses and adjustments from the effective date to the closing date are recorded as adjustments to the purchase price.

(i) Financial derivative contracts

Capitol documents its risk management objectives and strategies to manage exposures to fluctuations in commodity prices. Capitol's risk management policies include the use of derivative financial instruments, including price collars, to manage fluctuations in commodity prices relating to future oil and natural gas production. Capitol does not use financial derivative contracts for trading or speculative purposes.

Financial derivative contracts that do not qualify as hedges, or are not designated as hedges, are recorded using the mark-to-market method of accounting whereby the fair value of financial derivative contracts is recognized in the balance sheet with changes in the fair value reported separately in the statement of operations. The estimated fair values of the financial derivative contracts are based on quoted market prices.

(j) Stock based compensation

The Company uses the fair value method of accounting for stock based compensation. Under this method, all equity instruments granted are measured and recognized based on the fair value of the equity instruments issued. Compensation expense for equity instruments granted to employees is recognized over the period of related employee service, usually the vesting period of the equity instrument awarded.

(k) Flow-through shares

The Company may finance a portion of its exploration activities through the issuance of flow-through common shares. Under the terms of the flow-through agreement, the resource expenditure deductions for income tax purposes are renounced to investors in accordance with the appropriate income tax legislation. The Company provides for the future effect on income tax related to flow-through shares when flow-through share amounts are renounced.

(l) Per share amounts

Basic and diluted earnings and net income per share are calculated using the weighted average number of voting and non-voting common shares outstanding during the year.

The Company uses the treasury stock method to determine the dilutive effect of stock options and warrants. Diluted calculations reflect the weighted average incremental common shares that would be issued upon exercise of dilutive options and warrants assuming the proceeds would be used to repurchase common shares at the average market price for the period. Anti-dilutive options and warrants are excluded from the calculation.

(m) Comparative figures

Certain comparative figures from the prior year have been reclassified to conform to the current year presentation.

(In thousands of dollars unless otherwise noted)

3. Property and Equipment

As at December 31,	2006	2005
Oil and natural gas properties and production equipment	**$ 205,600**	$ 124,208
Administrative assets	**374**	321
	205,974	124,529
Accumulated depreciation and depletion	**(29,957)**	(8,297)
	$ 176,017	$ 116,232

General and administrative expenses of $1,156 (2005 - $710) and stock based compensation expenses of $537 (2005 - $Nil) were capitalized during the year in accordance with the Company's full cost accounting policy.

All property and equipment costs are subject to depletion and depreciation at December 31, 2006, with the exception of unproved property costs of $4,762 (2005 - $4,740). Future expenditures totaling $130,462 (2005 - $61,165) relating to costs to develop proved reserves and asset retirement costs associated with proved undeveloped reserves have been included in costs subject to depletion and depreciation at December 31, 2006.

The benchmark prices used in the ceiling test evaluation of the Capitol's property and equipment as forecast by Capitol's independent qualified reserves evaluator at December 31, 2006 were:

	Oil			Natural Gas	
	WTI ($US/Bbl)	Edmonton Light Crude ($C/Bbl)	Capitol Realized Price ($C/Bbl)	AECO Spot ($C/GJ)	Capitol Realized Price ($C/mcf)
2007	62.50	70.80	55.22	6.85	6.99
2008	61.20	69.30	54.75	7.05	7.23
2009	59.80	67.70	52.93	7.40	7.57
2010	58.40	66.10	52.24	7.50	7.67
2011	56.80	64.20	50.75	7.70	7.87

Escalating thereafter at approximately 2%

4. Acquisition of Tiger Energy Limited

On February 28, 2005, Capitol acquired all of the common shares of Tiger Energy Limited ("Tiger"), a Calgary based private exploration company active in west central Alberta for cash consideration of $49,352 subject to working capital adjustments pursuant to a plan of arrangement.

Tiger was wound up into Capitol upon closing. The business combination has been accounted for using the purchase method with results of operations of Tiger included in the financial statements from the date of acquisition.

The calculation of the purchase price and the allocation to assets and liabilities was as follows:

Cash paid for common shares of Tiger	$	49,352
Transaction costs		162
Total purchase price	**$**	**49,514**
Fair value of assets and liabilities assumed		
Property, plant, and equipment	$	47,251
Current assets (including $3,430 of cash)		6,819
Current liabilities		(4,193)
Asset retirement obligation acquired		(363)
Total assets and liabilities assumed	**$**	**49,514**

(In thousands of dollars unless otherwise noted)

Future income taxes payable of $11,089 resulting from temporary differences between allocated values and tax values for Tiger's assets and liabilities were eliminated through the recognition of Capitol's previously unrecognized tax assets.

5. Bank Loan

At December 31, 2006, the Company had a revolving credit facility of $45,000 repayable on demand and bearing interest, calculated daily and payable monthly, based on a pricing grid which varies based on Capitol's debt to cash flow ratio and the borrowing instrument utilized. At December 31, 2006, Capitol had drawn $26,723 (2005 - $Nil) against the revolving credit facility at an interest rate of bank prime plus 0.25%.

At December 31, 2006, the Company had a non-revolving development facility of $15,000, repayable on demand or at $300 per month commencing on February 28, 2007. At December 31, 2006, Capitol had drawn $7,000 (2005 - $Nil) against the non-revolving development facility at an interest rate of bank prime rate plus 0.50%, calculated daily and payable monthly.

The revolving and non-revolving development facilities are secured by a first floating charge debenture for $75,000 over the Company's oil and gas properties and are subject to an interim review by April 30, 2007.

6. Asset Retirement Obligation

As at December 31,	**2006**	2005
Balance, beginning of year	**$ 1,641**	$ 259
Liabilities incurred	**958**	877
Accretion expense	**145**	52
Change in estimated future cash flows	**(365)**	200
Liabilities settled	**-**	(110)
Acquired on business combination (note 4)	**-**	363
Balance, end of year	**$ 2,379**	$ 1,641

The Company's asset retirement obligation results from net ownership interest in oil and natural gas assets including well sites, gathering systems and processing facilities. At December 31, 2006, the Company estimates the total undiscounted amount of cash flows required to settle the asset retirement obligations is $5,641 (2005 - $4,346) with the majority of expenditures expected to be after 2026. In calculating the Company's future asset retirement obligation an annual credit adjusted risk free interest rate of 7.0% and an annual inflation rate of 2.5% were used (2005 – interest rate of 7.0%, inflation rate of 2.5%).

7. Income Taxes

The provision for future income taxes recorded in the financial statements differs from the amount expected by applying applicable statutory rates. Differences are as a result of the following:

For the years ended December 31,	**2006**	2005
Net income (loss) before taxes	**$ 4,112**	$ (4,564)
Statutory Canadian corporate tax rate	**34.50%**	37.62%
Anticipated tax expense (recovery)	**1,419**	(1,717)
Non-deductible crown payments net of ARTC	**1,837**	848
Resource allowance	**(2,074)**	(937)
Stock based compensation	**1,201**	1,891
Expiry of non-capital losses	**-**	168
Change in enacted rate	**395**	-
Other	**92**	208
Change in valuation allowance	**-**	(14,113)
Future income tax expense (recovery)	**$ 2,870**	$ (13,652)

(In thousands of dollars unless otherwise noted)

In 2005, a future income tax recovery was recorded on the renunciation of flow-through share expenditures and the recognition of future income tax assets on a "more likely than not" basis.

During the year the Company recorded current taxes of $26 in relation to federal large corporation's tax (2005 - $88).

The components of the Company's future income tax assets and liabilities are as follows:

As at December 31,	2006	2005
Future income tax liabilities		
Net book value of property and equipment in excess of tax deductions	**$ (211)**	$ (5,089)
Risk management asset	**(184)**	-
Future income tax assets		
Non-capital loss carry-forwards	**3,474**	12,305
Share issue costs	**1,564**	1,812
Asset retirement obligation	**690**	552
Scientific research and development expenditures	**650**	754
Other	**281**	248
Net future income tax assets	**6,264**	10,582
Valuation allowance	**(32)**	(37)
Future income tax asset	**$ 6,232**	$ 10,545

In conjunction with the business combination with Tiger in 2005 (note 4), the Company recognized a future income tax benefit of approximately $11,089 to eliminate future tax on the excess of allocated values over Tiger's tax basis.

The Company had approximately $195,900 of accumulated tax deductions, including non-capital losses of approximately $10,900, at December 31, 2006 for application against future taxable income.

The Company's non-capital losses expire on June 30 of the following years:

	Amount
2009	$ 4,600
2010	1,800
2013	900
2014	3,600
Non-capital losses available	**$ 10,900**

8. Share Capital

(a) Authorized

Unlimited number of common shares without par value
Unlimited number of preferred shares to be issued in series

(b) Share consolidation and conversion of non-voting common shares

Upon approvals at the Annual General and Special Meeting of voting common shareholders and the Special Meeting of non-voting common shareholders held on May 4, 2005, the Company's voting common shares were consolidated on the basis of one new common share for each five voting shares outstanding and the Company's non-voting common shares were converted into voting common shares, on the basis of one new common share or each five non-voting common shares outstanding. The non-voting common shares were then deleted as an authorized class of shares of the Company.

(In thousands of dollars unless otherwise noted)

All information related to common shares, stock options, share warrants and per share amounts has been restated to give effect to the share consolidation and non-voting share conversion in May 2005.

(c) Shares issued and outstanding

	Voting	Non-Voting	Amount
Outstanding at December 31, 2004	**13,166,976**	**9,188,749**	**$ 28,178**
Issued on conversion of subscription receipts	18,181,818	-	50,000
Tax effect of flow-through shares	-	-	(5,124)
Issued on exercise of warrants	44,092	-	198
Issued on exercise of options	13,967	-	70
Non-voting shares conversion to voting shares	9,188,749	(9,188,749)	-
Private placement – flow-though shares	940,875	-	5,517
Private placement – common shares	6,452,000	-	30,002
Share issue costs	-	-	(4,994)
Tax effect of share issue costs	-	-	2,017
Outstanding at December 31, 2005	**47,988,477**	**-**	**$ 105,864**
Private placement – common shares	4,945,000	-	23,489
Issued on exercise of options	41,333	-	309
Share issue costs	-	-	(1,375)
Tax effect of share issue costs	-	-	412
Tax effect of flow-through shares	-	-	(1,855)
Outstanding at December 31, 2006	**52,974,810**	**-**	**$ 126,844**

(d) Flow-through shares

The Company did not issue flow-through shares during 2006. During 2005, the Company issued common shares on a flow-through basis for gross proceeds of $5,517.

In accordance with Canadian accounting standards, foregone tax benefits on flow-through shares have been reflected as a reduction in share capital upon renouncement of amounts to shareholders.

At December 31, 2006, the Company had incurred all amounts in respect of flow-through share commitments.

(e) Warrants

At December 31, 2006, 10,000 warrants with an exercise price of $19.10 and an expiry date of March 28, 2007 were outstanding to purchase the Company's shares.

During 2006, no warrants were exercised and 25,000 warrants expired. During 2005, 44,092 warrants were exercised for proceeds of $198 and 150,351 warrants expired.

(f) Shares in escrow

During 2006, 4,504,576 shares were released from escrow (2005 – 683,100 shares released from escrow). At December 31, 2006, there were no shares held in escrow (2005 – 4,504,576 shares held in escrow).

(In thousands of dollars unless otherwise noted)

(g) Contributed surplus

The following table summarizes changes to contributed surplus for the periods:

As at December 31,	2006	2005
Contributed surplus, beginning of year	**$ 6,203**	$ 1,199
Amortization of fair value of options	**3,483**	5,025
Exercised options	**(117)**	(21)
Balance, end of year	**$ 9,569**	$ 6,203

(h) Shareholders' rights plan

During 2006, Capitol's Board of Directors adopted a Shareholders' Rights Plan (the "Rights Plan"). The Rights Plan's objectives are to ensure, to the extent possible, that all shareholders of the Company are treated equally and equitably in connection with any takeover bid for the Company.

The Rights Plan has been conditionally approved by the Toronto Stock Exchange, and requires approval by Capitol's shareholders by May 14, 2007.

Under the Rights Plan, one right (a "Right") has been issued in respect of each common share of the Company outstanding. The Rights trade with and are represented by the common shares. If a person, or a group acting jointly or in concert, acquires, other than pursuant to an exemption available under the Rights Plan, beneficial ownership of 20% or more of the common shares outstanding, the Rights will separate from the common shares and permit the holder to purchase common shares at a 50% discount to their market price. At any time prior to the Rights becoming exercisable, the Board of Directors may waive the operation of the Rights Plan.

The issuance of the Rights is not dilutive and does not affect earnings per share until the Rights separate from the underlying common shares and become exercisable or are exercised.

9. Stock Options

The following tables summarize information about options to purchase common shares:

	Number	Weighted Average Exercise Price
Outstanding at December 31, 2004	**1,166,195**	**$ 3.82**
Granted	2,241,000	4.81
Exercised	(13,967)	3.50
Forfeited	(27,933)	3.50
Outstanding at December 31, 2005	**3,365,295**	**$ 4.48**
Granted	950,200	4.81
Exercised	(41,333)	4.65
Expired	(21,891)	5.31
Forfeited	(52,667)	4.45
Outstanding at December 31, 2006	**4,199,604**	**$ 4.55**

(In thousands of dollars unless otherwise noted)

	Outstanding Options			Exercisable Options	
Range of Exercise Price	**Number**	**Weighted average exercise price**	**Weighted average years to expiry**	**Number**	**Weighted average exercise price**
$3.40-$4.85	2,650,600	$ 4.19	3.3	1,818,800	$ 3.96
$5.00-$5.50	1,529,004	5.02	3.3	1,019,671	5.02
$15.50-$16.00	20,000	15.75	0.4	20,000	15.75
Total	**4,199,604**	**$ 4.55**	**3.3**	**2,858,471**	**$ 4.42**

Options granted have been accounted for using the fair value method. The fair value of common share options granted during the year ended December 31, 2006, is estimated to be $2.37 per option, $2,248 in total (2005 - $3.02 per option, $6,762 in total) as at the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

For the years ended December 31,	**2006**	2005
Risk free interest rate	**5%**	5%
Expected life	**5 years**	5 years
Expected volatility	**49%**	73%
Expected dividend yield	**0%**	0%

The Company's options vest one third on their grant date, and one third on each of the first and second anniversary dates of the options. One third of the estimated fair value of the options is expensed on the grant date with the balance amortized to stock based compensation expense over the balance of the vesting period on a straight-line basis.

For the year ended December 31, 2006, stock based compensation costs of $3,483 (2005 - $5,025) were recognized of which $2,946 (2005 - $5,025) were expensed in the income statement and $537 (2005 - $Nil) were capitalized in accordance with the Company's full cost accounting policy.

10. Financial Instruments and Credit Risk

(a) Balance sheet

Capitol's financial instruments recognized in the balance sheet include cash and short-term investments, accounts receivable, current liabilities and the bank loan. The fair values of these financial instruments approximate their book amounts due to the short-term maturity of these instruments and the market rate of interest applied to the bank loan.

Most of the Capitol's accounts receivable relate to oil and natural gas sales and are exposed to typical industry credit risks. Capitol manages its credit risk by entering into sales contracts with only credit worthy entities. The book value of the accounts receivable reflects management's assessment of the associated credit risks.

Capitol is exposed to interest rate risk on its bank debt as a result of its floating rate.

(b) Financial derivative contracts

Capitol's revenues from the sale of crude oil and natural gas are directly impacted by changes to the underlying commodity prices. To ensure that cash flows are sufficient to fund planned capital programs, Capitol commenced utilizing costless collars in November 2006 to ensure that commodity prices realized will fall into a contracted range for a contracted sales volume.

(In thousands of dollars unless otherwise noted)

Capitol uses financial derivative contracts to reduce its exposure to fluctuating oil and gas prices. The use of financial derivative contracts exposes the Company to credit risk with the possible non-performance of counterparties to the financial instruments. Capitol limits this risk by transacting only with financial institutions with high credit ratings.

At December 31, 2006, Capitol had financial derivative contracts for the following:

Contracts	Term	Volume	Price	Index	Fair market value
Crude Oil					
WTI costless collars	2007	300 bbls/d	$60 US - $72.60 US	WTI	$ 41
WTI costless collars	2007	500 bbls/d	$62 US - $70.23 US	WTI	99
WTI costless collars	2007	500 bbls/d	$60 US - $73.29 US	WTI	99
					$ 239
Natural Gas					
AECO-C seasonal costless collar	2007	2000 GJ/d	$6.50 - $10.40 (Jan–Mar) $6.50 - $8.75 (Apr–Oct) $6.50 - $10.40 (Nov– Dec)	AECO	**$ 332**

Capitol has not designated any of its financial derivative contracts as hedges and has recorded an asset of $571 at December 31, 2006 on the mark-to-market value of the outstanding financial derivative contracts. The change in the mark-to-market value of the financial derivative contracts during 2006 has been recorded as an unrealized gain on financial derivatives of $571 (2005 – $Nil) in the statement of operations.

The following table reconciles the changes in the fair value of Capitol's risk management financial instruments:

For the years ended December 31,	**2006**	2005
Balance beginning of year	**$ -**	$ -
Net change in fair value of financial derivative contracts outstanding as at December 31	**571**	-
Balance end of year	**$ 571**	$ -

11. Related Party Transactions

(a) Services

During 2006, the Company incurred costs of $94 in respect of legal services provided by a firm in which a director of the Company is a partner (2005 - $285). At December 31, 2006, a payable of $70 existed (2005 - $36).

The services were conducted in the normal course of operations and are measured at the exchange amount which is established and agreed to by the related parties based on standard rates, time spent and costs incurred.

(b) Shares

During 2005, management, directors and employees purchased 276,928 common shares through private placements for proceeds of $784 and 120,875 flow-through shares for $515. With the exception of shares issued pursuant to stock option agreements (note 8) management, directors and employees did not purchase any shares during 2006.

(In thousands of dollars unless otherwise noted)

12. Commitments

	200720	08	2009	2010	2011	Thereafter	Total
Capital commitments	$ 700	$ -	$ -	$ -	$ -	$ -	$ 700
Office lease	261	268	246	-	-	-	775
Total	**$ 961**	**$ 268**	**$ 246**	**$ -**	**$ -**	**$ -**	**$ 1,475**

The Company has contracted two drilling rigs for a minimum of 250 days each between June 1, 2006 and May 31, 2007. The Company has the option to release one or both rigs with nominal notice.

13. Supplementary Information

(a) Per share amounts

The following table summarizes the common shares used in calculating net income and cash flow per share:

For the years ended December 31,	**2006**	2005
Weighted average common shares outstanding – basic	**50,240**	39,617
Effect of dilutive stock options and warrants	**328**	218
Weighted average common shares outstanding – diluted	**50,568**	39,835

The amounts above have been restated to reflect the effect of the common share consolidation in May 2005.

(b) Changes in non cash working capital

For the years ended December 31,	**2006**	2005
Decrease (increase) in non-cash working capital		
Accounts receivable	**$ (2,118)**	$ (4,700)
Other current assets	**(45)**	(150)
Accounts payable and accrued liabilities	**(6,044)**	13,785
Less amounts acquired through business combination with Tiger (note 4)	**-**	(804)
Net change in non-cash working capital	**$ (8,207)**	$ 8,131
Relating to		
Operating activities	**$ (525)**	$ (1,718)
Investing activities	**(7,682)**	9,849
	$ (8,207)	$ 8,131

(c) Interest and income taxes paid

For the years ended December 31,	**2006**	2005
Interest paid	**$ 1,512**	$ 122
Income taxes paid	**$ 57**	$ 57